Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:OHI:CIN:TL-N-1849-00
JEKagy

date:

to: Chief, Examination Division, Ohio District
Attn: Carl Schneider (E:EB:1204)

from: Assistant District Counsel, Ohio District, Cincinnati

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subject: [redacted] Specified Liability Loss

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This memorandum responds to your inquiry of March 22, 2000, as supplemented on March 31, 2000. You sought our review of a number of [redacted] settlement agreements executed by the taxpayer and certain non-related insurers and, more particularly, our opinion on whether the settlement amounts agreed to be paid by the insurers should be considered contingent, with no substantial expectation of payment, or as representing fixed contractual rights of reimbursement.

ISSUE:

Whether a portion of the settlement proceeds agreed to by [redacted], [redacted], [redacted], and [redacted] should be used to reduce the litigation and settlement expenses incurred by the taxpayer during the years [redacted] through [redacted].

CONCLUSION:

Our review of the settlement documents found no merit to the taxpayer's claim that the settlement proceeds were contingent, with no expectation of payment. To the contrary, the settlement payments appear to represent fixed contractual payments due from the insurers. Thus, the litigation and settlement expenses claimed by the taxpayer must be reduced by a portion of the settlement proceeds.

FACTS:

[redacted] ("[redacted]" or the "Company") has been a co-defendant in numerous personal injury and property damage civil actions along with various other former manufacturers, distributors and installers of products containing [redacted]. The personal injury claimants generally alleged injuries to their [redacted] caused by [redacted] of [redacted] [redacted] from the Company's products. Historically, the Company had attempted to insulate itself from some of its potential casualty liability exposure through the purchase of insurance policies with many non-related insurance carriers. As related to the instant matter, the insurers resisted making payments to [redacted] under the various casualty policies, claiming that the policies not only were not intended to cover [redacted] [redacted] injuries, but could not be interpreted to cover such injuries.

On [redacted], a majority of the Company's primary insurance carriers executed what is called the "[redacted]", admitting insurance liability relative to the [redacted] claims against [redacted] and agreeing to a collective methodology for the payment of the [redacted] [redacted] claims against the Company. [redacted] refers to insurance companies which were party to the [redacted] as "Signatory" carriers and to those insurance carriers implicated in the [redacted] lawsuits but who refused to sign the [redacted] as "Non-Signatory" carriers.

From [redacted] through [redacted], the Company was a party to a declaratory judgment action[1] it had filed against several of its excess insurers (Non-Signatory carriers) with regard to the [redacted] products liability claims. The Company sought a court declaration that each of the defendant-insurers was jointly and severally liable to indemnify the Company for [redacted] liability incurred during the relevant coverage period. By the end of [redacted], settlements had been reached with all of the carriers.

As of [redacted], approximately [redacted] personal injury claims were still pending against the Company even though the Company already had resolved (by settlement or otherwise) approximately [redacted] personal injury claims. More particularly, during [redacted], and [redacted], the Company resolved approximately [redacted] to [redacted] such claims, incurring total indemnity payments of $[redacted]. The Company's indemnity payments have varied considerably over time and from case to case, and are affected by a multitude of factors.

As a general matter, each year the Company claimed a deduction for the tort claims paid during the year, although reduced by an allocable portion of the insurance proceeds to which it was entitled from its Signatory insurance carriers. By approximately [redacted], however, the Company had exhausted all of their insurance coverage with "Signatory" carriers. For the Non-Signatory carriers, the Company recognized the insurance proceeds only when received, not when billed (i.e. cash basis).

Apparently, the Company's position is that for those carriers who are not signatories to the [redacted], the insurance proceeds are not fixed and, therefore, not recognized. At issue is the proper accounting for the proceeds of the settlements with [redacted], four Non-Signatory companies.

ANALYSIS:

Generally, section 162 permits the deduction of ordinary and necessary business expenses. Moreover, payments to defend against and in satisfaction of a products liability lawsuit are often considered to be ordinary and necessary expenses. See Kornhauser v. United States, 276 U.S. 145 (1928).

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[1] See [redacted] (later re-captioned [redacted], No. [redacted].

The agent proposes to disallow those expenses claimed by [redacted] which are allocable or traceable to liability coverage provided by one of the above four Non-Signatory carriers. The agent suggests that the taxpayer should not be allowed a deduction for an expense for which there is a right or expectation of reimbursement through insurance or otherwise. Ample authority exists for that position. See, e.g., Rev. Rul. 78-388, 1978-2 C.B. 110. The reimbursement theory is premised on the principle that the disallowed expenditures are in the nature of loans or advancements and are not ordinary and necessary business expenses. In effect, payments by a taxpayer that are reimbursable are not expenses of that taxpayer.

Case law supports the agent's position. For instance, attorneys may not deduct as ordinary and necessary business expenses the various litigation costs advanced for clients on contingent fee cases where the advances are to be repaid strictly from any favorable judgment or settlement and the client owes nothing if no recovery is realized. See Canelo v. Commissioner, 53 T.C. 217 (1969), aff'd, 447 F.2d 484 (9th Cir. 1971) (advances to clients operated as loans rather than section 162 expenses; taxpayer had "good hopes of recovery" of the amounts advanced to clients). See also Herrick v. Commissioner, 63 T.C. 562 (1975) (case preparation and litigation costs paid were in nature of loans and do not constitute deductible business expenses).

Where only a general right of reimbursement exists, however, the expenses may be deductible as ordinary and necessary business expenses. See Electric Tachometer Corp. v. Commissioner, 37 T.C. 158 (1961), acq. 1962-2 C.B. 4 (from the time the property was condemned, only a general right to recover damages, including moving expenses, existed and because it was uncertain whether the taxpayer would be reimbursed for the moving expenses, they were ordinary and necessary deductible business expenses in the years in which incurred).

On the opposite end of the spectrum are cases where the right of reimbursement is absolute or unequivocal. In Glendinning, McLeish & Co. v. Commissioner, 61 F.2d 950 (2d Cir. 1932), the taxpayer entered into an agreement with another company which provided for reimbursement of certain expenditures. When the reimbursable payments were incurred in accordance with the agreement but were not reimbursed, the amounts were claimed as ordinary and necessary business expense deductions. In sustaining the Commissioner's disallowance, the Second Circuit stated that the disputed deductions could not be expenses because they were advanced in accordance with an agreement which provided that the amounts would be repaid to the taxpayer. "The agreement

for reimbursement made them ... advances." As such they were not deductible. Id. at 952.

It seems well settled that expenses for which there exists a right of reimbursement are not ordinary and necessary business expenses within the meaning of the Internal Revenue Code. See Levy v. Commissioner, 212 F.2d 552, 554 (5th Cir. 1954). The rule has been followed even when the right to reimbursement was contingent, and there was only the expectation of substantial repayment. See Flower v. Commissioner, 61 T.C. 140 (1973), aff'd, 505 F. 2d 1302 (5th Cir. 1974); Burnett v. Commissioner, 356 F.2d 755 (5th Cir. 1966), cert. denied, 385 U.S. 832 (1966) (deductions were denied where there was an obvious expectation of reimbursement, and the advances were virtually certain to be repaid). While an absolute right to reimbursement as recognized in Burnett may not be required, it is clear that each case must be evaluated to determine whether the probability of reimbursement is sufficient to justify denying a deduction.

From our review of the documents provided, it appears that [redacted] had almost an absolute right to the reimbursement of its expenditures, although receipt would not occur until the future. For instance, the [redacted] companies[2] settled with [redacted] on or about [redacted], and agreed to make payments[3] of $[redacted] regarding policies at issue, beginning in [redacted] and running through [redacted]. We have reviewed the settlement documents and have found little support for the taxpayer's position that significant impediments exist to its gaining the contractual reimbursements. To the contrary, [redacted]'s right to reimbursement from [redacted] (through the payment of insurance proceeds) appears to have been fixed at the time of signing the settlement agreement and virtually certain to be paid. The [redacted] settlements with the other insurance companies were similar.[4]

Consequently, from our review of the settlement documents supplied, we agree with your conclusion that the taxpayer should not be allowed a deduction for the tort claims covered by these settlement agreements. The settlement payments appear to

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[2] The "future" reimbursement payments due from the [redacted] companies comprise approximately 97% of the disputed deductions.

[3] See "Settlement Agreement By and Among [redacted] and The [redacted] Companies", p. 9.

[4] For instance, with regard to the "future" payments, [redacted] agreed on [redacted], to irrevocably pay $[redacted] (in immediately available funds) to [redacted] on or before [redacted].

represent fixed contractual payments due from the insurers, an allocable portion of which insurance proceeds should offset the litigation and settlement expenses claimed by the taxpayer.

Factually, the strength of your issue will turn, in part, upon the Service's ability to establish that each of the liabilities paid by the taxpayer is specifically traceable to a specific insurance contract and a portion of the payment is allocable to the future insurance payments. We understand that, pursuant to a methodology established by the [redacted], the taxpayer already allocates each of its payments to the various individual insurance policies. If we have not obtained a copy of the [redacted] already, we should do so as soon as possible. Further, it is in the Service's best interest for the agents to obtain copies of all relevant payment allocations prepared by or for the taxpayer and to obtain as complete of an understanding of the methodology used to prepare the allocation as is possible.

If we may be of further assistance in this matter, please contact the undersigned at your convenience.

MATTHEW J. FRITZ
Assistant District Counsel

By: _____
JAMES E. KAGY
Special Litigation
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